Annual State Retirement and Pension System Investment Overview

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Annual State Retirement and Pension System's Investment Overview

At the request of the Joint Committee on Pensions, the Department of Legislative Services (DLS) annually reviews the investment performance of the State Retirement and Pension System (SRPS) for the preceding fiscal year. This report is intended to provide an overview of SRPS performance, a comparison of this performance to its peers, and an identification of issues meriting further comment by the State Retirement Agency (SRA).

State Retirement and Pension System Investment Performance

Asset Allocation

The SRPS Board of Trustees sets the allocation of assets to each investment class and continuously monitors the appropriateness of the allocation in light of its investment objectives. The SRPS *Investment Policy Manual* sets forth the investment objectives:

> The Board desires to balance the goal of higher long-term returns with the goal of minimizing contribution volatility, recognizing that they are often competing goals. This requires taking both assets and liabilities into account when setting investment strategy, as well as an awareness of external factors such as inflation. Therefore, the investment objectives over extended periods of time (generally, 10 to 20 years) are to achieve an annualized investment return that:
>
> 1. In nominal terms, equals or exceeds the actuarial investment return assumption of the System adopted by the Board. The actuarial investment return assumption is a measure of the long-term rate of growth of the System's assets. In adopting the actuarial return assumption, the board anticipates that the investment portfolio may achieve higher returns in some years and lower returns in other years.
>
> 2. In real terms, exceeds the U.S. inflation rate by at least 3%. The inflation-related objective compares the investment performance against the rate of inflation as measured by the Consumer Price Index (CPI) plus 3%. The inflation measure provides a link to the system's liabilities.
>
> 3. Meets or exceeds the system's Investment Policy Benchmark. The Investment Policy Benchmark is calculated by using a weighted

average of the board-established benchmarks for each asset class. The Policy Benchmark enables comparison of the system's actual performance to a passively managed proxy and measures the contribution of active investment management and policy implementation.

The assets allocation is structured into five categories:

- ***Growth Equity:*** public equity (domestic, international developed, and international emerging markets) and private equity investments;
- ***Rate Sensitive:*** investments in bonds, loans, or associated derivatives with an average portfolio credit quality of investment grade;
- ***Credit:*** investments in bonds, loans, or associated derivatives with an average portfolio credit quality of below investment grade;
- ***Real Assets:*** investments whose performance is expected to exceed the rate of inflation over an economic cycle; and
- ***Absolute Return:*** consists of investments that are expected to exceed the three-month U.S. Treasury bill by 4-5% over a full market cycle and exhibit low correlation to public stocks.

Included within these asset classes are sub-asset classes. The board approves adjustments to the asset allocations and sets transitional targets. The board also approves target ranges for sub-asset classes as well as constraints on hedge fund exposure, with total hedge fund investments capped across all asset classes. In fall 2021, the board made adjustments to the system's asset allocation. **Exhibit 1** shows system asset allocations in relation to the strategic targets in effect on June 30, 2021, and under the changes adopted in September 2021.

Exhibit 1
State Retirement and Pension System Asset Allocation

Asset Class	Target June 30, 2021	Target September 21, 2021
Growth Equity		
U.S. Equity	16%	15%
International Equity	10%	9%
Emerging Markets Equity	11%	10%
Private Equity	13%	16%
Subtotal	***50%***	***50%***
Rate Sensitive		
Long-term Government Bonds	10%	10%
Cash and U.S. Investment Grade Bonds	5%	6%
Inflation-linked Bonds	4%	5%
Subtotal	***19%***	***21%***
Credit/Debt		
High Yield Bonds and Bank Loans	7%	4%
Emerging Market Debt	2%	4%
Subtotal	***9%***	***8%***
Real Assets		
Real Estate	10%	10%
Natural Resources and Infrastructure	4%	5%
Subtotal	***14%***	***15%***
Absolute Return	**8%**	**6%**
Total Fund	**100%**	**100%**

Note: Columns may not add to total due to rounding.

Source: State Street – State Retirement Agency of Maryland – Rates of Return – Net Mgr – Periods Ending June 30, 2021; State Retirement and Pension System

The system's asset allocation is reflective of a decision to restructure the portfolio in fiscal 2008 and 2009. The overall strategy is part of an approach by the board to decrease risk through diversification in the wake of the 2008 financial crisis. Increased investment in private equity has resulted in positive returns for the system with less experienced volatility than public equity. Lower allocations to public equity investments are expected to result in lower returns when public equities are in growth patterns. However, as public equity can be a highly volatile asset class, a more diverse investment allocation should reduce volatility to provide protection when equity markets perform poorly or decline. While mitigating volatility will result in not taking full advantage of highly performing public equity markets, more stable investment returns will also mitigate swings in employer contribution rates. The board of trustees and the investment committee monitor the allocation of assets and continue to discuss the appropriate allocation (in consultation with the system's investment staff and investment consultants) that will achieve the system's investment return needs. Given the certain nature of defined benefit payment obligations, prudent allocation strategy should consider both achieving positive returns as well as being positioned to avoid losses. While investment division staff have some authority to make tactical, short-term adjustments to asset allocations, the *Investment Policy Manual* states an objective of long-term investment strategy, acknowledging the system's long-term investment horizon may lead to short-term volatility.

The asset allocation targets for the period ending June 30, 2021, were put in effect on October 1, 2017. As part of its periodic review of the asset allocation targets, the board-adopted changes recommended by the system's investment consultant and the investment division. The changes adopted in September 2021 include increased allocations to private equity (one of the strongest performing asset classes) and a decrease in the target allocation to the absolute return asset class. The system's *Investment Policy Manual* for the board of trustees for SRPS will reflect actions of the board altering the asset allocation and can be found on SRA's website.

Investment Performance

The system's investment return for fiscal 2021 was 26.69% net of management fees, exceeding the assumed rate of return of 7.40%. The system also exceeded its policy benchmarks for the system as a whole, driven by returns in the growth equity asset class. System performance was driven primarily by growth equity returns, which made up 52.6% of the portfolio and returned 47.08% for the fiscal year, which was 253 basis points above its benchmark. The system was able to weather the volatility introduced into markets with the spread of the COVID-19 pandemic and the interruption of economic activity resulting from public health measures taken to curb the spread of the virus.

As shown in **Exhibit 2**, the system's assets totaled $67.9 billion as of June 30, 2021 – a significant increase over the $54.8 billion in assets at the end of fiscal 2020.

Significant investment gains or losses can impact the allocation of the investment portfolio to certain asset classes. The asset allocation targets set by the board are intended to maintain an acceptable risk tolerance for the system, providing protection for the system against investment volatility. The investment returns of each asset class can result in deviation from the target allocations, requiring additional oversight to maintain the overall asset allocation within the system's established risk tolerance.

Exhibit 2
State Retirement and Pension System of Maryland
Fund Investment Performance for Periods Ending June 30, 2021
($ in Millions)

			Time Weighted Total Returns		
	Assets	**% Total**	**1 Year**	**5 Years**	**10 Years**
Growth Equity					
Public Equity	$24,155	35.5%	44.54%	15.07%	10.50%
Private Equity	11,577	17.1%	51.85%	19.76%	15.97%
Subtotal	***$35,732***	***52.6%***	***47.08%***	***16.38%***	***11.62%***
Rate Sensitive					
Nominal Fixed Income	$8,148	12.0%	-5.31%	4.36%	4.81%
Inflation Sensitive	2,677	3.9%	6.61%	4.29%	3.85%
Subtotal	***$10,825***	***15.9%***	***-2.53%***	***4.40%***	***4.70%***
Credit/Debt					
High Yield Bonds and Bank Loans	$4,918	7.2%	15.90%	7.33%	6.98%
Non-U.S. Credit	1,316	1.9%	8.70%	4.55%	0.60%
Subtotal	***$6,235***	***9.2%***	***14.36%***	***6.41%***	***6.08%***
Real Assets					
Real Estate	$5,023	7.4%	8.80%	6.42%	9.04%
Natural Resources and Infrastructure	2,565	3.8%	27.31%	4.88%	5.22%
Subtotal	***$7,599***	***11.2%***	***14.81%***	***5.29%***	***2.90%***
Absolute Return	**$5,882**	**8.7%**	**15.51%**	**4.36%**	**3.38%**
Multi Asset	**$668**	**1.0%**	**24.11%**	**n/a**	**n/a**
Cash and Cash Equitization	**$943**	**1.4%**	**2.04%**	**5.32%**	**3.85%**
Total Fund	**$67,883**	**100.0%**	**26.69%**	**10.68%**	**8.15%**

Note: Returns beyond one year are annualized. Returns are net of fees. Columns may not add to total due to rounding.

Source: State Street – State Retirement Agency of Maryland – Rates of Return – Net Mgr – Periods Ending June 30, 2021

DLS requests SRA to comment on actions taken to maintain target asset allocations, and how the system managed its asset allocation during fiscal 2021 while experiencing significant investment growth.

As shown in **Exhibit 3**, the system as a whole performed 2.27% (227 basis points) above the benchmark, further enhancing the system's record returns for the fiscal year. With the exception of the rate sensitive asset class, all of the major asset classes – including their sub-asset classes – achieved returns in excess of the assumed rate of return of 7.40%. The rate sensitive asset class returned -2.53% for the year, though this outperformed the benchmark of -3.91%. The system's private equity assets had the most significant return – 51.85% – though underperforming its benchmark. Public equity had the most significant performance, beating its benchmark by 4.03%. The real assets, absolute return, and multi asset classes all returned at least twice the assumed rate of return, but also all underperformed their benchmarks.

Exhibit 3
State Retirement and Pension System of Maryland
Benchmark Performance for Year Ending June 30, 2021

	Return	Return Benchmark	Excess
Growth Equity	**47.08%**	**44.55%**	**2.53%**
Public Equity	44.54%	40.52%	4.03%
Private Equity	51.85%	53.13%	-1.28%
Rate Sensitive	**-2.53%**	**-3.91%**	**1.37%**
Nominal Fixed Income	-5.31%	-6.50%	1.20%
Inflation Sensitive	6.61%	6.51%	0.10%
Credit	**14.36%**	**12.82%**	**1.53%**
High Yield Bonds and Bank Loans	15.90%	14.63%	1.27%
Non-U.S. Credit	8.70%	6.56%	2.14%
Real Assets	**14.81%**	**16.30%**	**-1.48%**
Real Estate	8.80%	7.51%	1.29%
Natural Resources and Infrastructure	27.34%	37.07%	-9.73%
Absolute Return	**15.51%**	**15.86%**	**-0.34%**
Multi Asset	**24.11%**	**24.42%**	**-0.31%**
Cash and Cash Equitization	**2.04%**	**0.08%**	**1.95%**
Total Fund	**26.69%**	**24.42%**	**2.27%**

Source: State Street – State Retirement Agency of Maryland – Rates of Return – Net Mgr – Periods Ending June 30, 2021

DLS requests SRA to comment on the fiscal 2021 return performance in relation to the policy benchmarks. For any asset classes and asset sub-classes that underperformed the benchmark, SRA should comment on the factors that led to the underperformance, whether those factors are expected to negatively affect performance in fiscal 2022, and what actions are being taken to mitigate those factors from impacting the fiscal 2022 returns.

Performance Relative to Other Systems

One method of evaluating the system's investment performance is to compare the system's investment performance with the performance of other systems. The Wilshire Trust Universe Comparison Service (TUCS) rankings are useful for providing a big picture, snapshot assessment of the system's performance relative to other large public pension plans. In the TUCS analysis, the one-hundredth percentile represents the lowest investment return, and the first percentile is the highest investment return. According to TUCS, the system's fiscal 2021 total fund investment performance was rated in the sixty-fourth percentile among the public pension funds with at least $25 billion in assets, as shown in **Exhibit 4**. As the system has historically had a low allocation to equity investments compared to its peers – and domestic equity in particular – the system's investment policy will have a low TUCS ranking when equity markets are experiencing strong performance, as has been the case for a number of recent years. The long-term relative performance rankings have placed SRPS' relative total fund performance in the bottom quartile, with improvement in recent years. The TUCS rankings are based on returns gross of fees.

Exhibit 4

TUCS Percentile Rankings for Periods Ending June 30

Fiscal 2018-2021

	2018	2019	2020	2021
1 Year	75	60	53	64
3 Years	94	92	60	57
5 Years	84	88	71	75
10 Years	94	87	87	88

TUCS: Wilshire Trust Universe Comparison Service

Note: Rankings for systems greater than $25 billion.

Source: Wilshire Trust Universe Comparison Service

The impact of asset allocation on total system TUCS rankings can be seen in the system's TUCS rankings on performance within individual asset classes. While the system as a whole has experienced relatively low rankings when compared to peer systems, the system has experienced better relative performance by asset class, as shown in **Exhibit 5**. The difference in relative rankings between the system as a whole and the system by asset class – particularly for the long-term rankings – indicates that the asset allocation has impacted the relative ranking of the total system return, with the system having lower allocations to public equity, and domestic public equity in particular. This effect can also be seen in the ranking for total equity. The system does not have a bias to U.S. equity, which had strong performance in recent years. While the system ranks well in its performance in U.S. equity, the lesser amount of assets in U.S. equity will impact the total equity ranking compared to peer systems with higher allocations in U.S. equity.

Exhibit 5
TUCS Percentile Rankings for Periods Ending June 30, 2021

Asset Class	1-year	3-year	5-year	10-year
Total Equity	9	29	45	50
U.S. Equity	11	27	27	36
International Developed	49	37	42	63
International Emerging	33	40	30	n/a
Fixed Income	93	5	30	31
Private Equity	13	14	18	1
Real Estate	33	5	46	55

TUCS: Wilshire Trust Universe Comparison Service

Note: Rankings for systems greater than $1 billion.

Source: Wilshire Trust Universe Comparison Service

Recent historical returns have seen strong returns in public equity, which can be a highly volatile asset class. Allocations that limit exposure to more volatile assets should result in more stable employer contribution rates over time. An allocation that would result in mitigating volatility of returns (whether excess gains, returns below the assumed rate of return, or investment losses) will also mitigate the impact to employer contributions from contribution rate increases. A system's asset allocation should be impacted by a number of considerations that reflect a system's risk tolerance. A system's maturity (ratio of retirees to active members), funded status, assumed rate of return, benefit structure, regularity of full contributions, and other considerations factor into a system's risk tolerance. The importance of these factors will vary from plan to plan leading to different tolerances for risk, variation in investment allocations, and differences in annual returns.

TUCS provides data on the risk-return profile of its members that shows that the system's level of risk over the three-year period ending June 30, 2021, was below the median for other public funds with assets greater than $25 billion. This is consistent with the system's comparatively lower allocation to public equity that can be a highly volatile asset class. The system's asset allocation strategy is intended to protect against more extreme losses in down markets. Due to the nature of the benefits that the system's investments ultimately fund, there is prudence in setting an asset allocation that achieves the necessary investment returns with the lowest level of risk capable of achieving those returns.

DLS requests that SRA comment on the relative TUCS performance rankings by asset class and how overall asset allocation impacts the total system's TUCS rankings.

Investment Management Fees

As shown in **Exhibit 6**, SRPS incurred $544.0 million in investment management fees during fiscal 2021, an increase from $364.1 million in fiscal 2020 fees. The increase is largely attributable to the $13.6 billion in growth of the system's assets and corresponding incentive-based fee arrangements, which increased from $38.6 million in fiscal 2020 to $169.2 million in fiscal 2021. Management fees for the plan have grown substantially since the system adjusted its asset allocation to invest more heavily in alternative asset classes with higher fee structures. The shift of public equity assets to global and emerging market equity managers, which are almost all active managers, has also contributed to the growth in fees over the past few years. As a percent of assets under management, management fees in fiscal 2021 were higher than in fiscal 2020 by 18.4 basis points.

Exhibit 6
Asset Management Fees Paid by Asset Class
Fiscal 2019-2020
($ in Millions)

	2020				2021			
Asset Class	**Management Fee**	**Incentive Fee**	**Total**	**Fees as % of Asset**	**Management Fee**	**Incentive Fee**	**Total**	**Fees as % of Asset**
Equity	$69.4	$1.2	$70.7	0.39%	$83.1	$43.5	$126.6	0.64%
Rate Sensitive	13.4	6.0	19.4	0.30%	14.2	19.9	34.1	0.50%
Credit	6.3	n/a	6.3	0.17%	7.5	n/a	7.5	0.17%
Private Equity	108.8	n/a	108.8	1.43%	125.3	n/a	125.3	1.27%
Real Estate	36.7	2.7	39.4	0.85%	38.1	0.4	38.5	0.81%
Real Return	16.2	n/a	16.2	0.87%	14.8	n/a	14.8	0.65%
Absolute Return	41.9	24.9	66.8	1.60%	52.6	91.5	144.1	2.75%
Multi Asset	1.5	n/a	1.5	0.18%	1.1	n/a	1.1	0.18%
Private Credit/Debt	15.1	n/a	15.1	1.36%	21.4	n/a	21.4	1.43%
Equity Long Short	8.6	3.8	12.5	1.99%	8.7	13.8	22.5	3.27%
Service Providers	7.8	n/a	7.8	n/a	8.1	n/a	8.1	n/a
Total Fund	**$325.5**	**$38.6**	**$364.1**	**0.68%**	**$374.9**	**$169.2**	**$544.0**	**0.87%**

Note: Columns may not sum to total due to rounding. "Fees as % of Asset" column indicates fees as a percentage of the average market value of the asset under management.

Source: State Retirement Agency

Review of the SRPS fees by the system's investment consultant has noted that SRPS has been effective at negotiating more favorable fee arrangements than peer systems. Transitioning assets to internal management is also expected to result in fee savings to the system.

Active Management

While active management of assets results in higher overall fees, the system has benefited from active management. The system has found passive investment strategies to be effective where available. However, active management is able to add more diversification to system investments by investing in assets where active management can generate returns in assets where passive investment is not available or efficient. **Exhibit 7** shows the system's performance where active and passive management are utilized. Actively managed U.S. and emerging market equities outperformed the passively managed assets during the short term as well as for the whole fiscal year. Actively managed U.S. nominal fixed income investments underperformed passively managed assets in short term. With respect to U.S. nominal fixed income, active management outperformed passively managed assets for the fiscal year by avoiding more losses.

Exhibit 7
Active and Passive Management Performance
Periods Ending June 30, 2021
($ in Millions)

	Assets	1 Month	3 Months	FYTD
U.S. Equity				
Passive Management	$3,552.4	2.20%	7.99%	45.26%
Active Management	$4,556.0	2.78%	8.25%	48.25%
Emerging Market Equity				
Passive Management	$41.0	0.15%	4.99%	40.44%
Active Management	$6,572.7	1.12%	6.31%	50.97%
U.S. Nominal Fixed Income				
Passive Management	$1,840.6	2.88%	4.99%	-5.41%
Active Management	$5,969.9	2.24%	4.17%	-1.70%

FYTD: fiscal year-to-date

Source: State Street – State Retirement Agency of Maryland – Rates of Return – Net Mgr – Periods Ending June 30, 2021

Absolute Return Fees

Absolute return fee structures typically include base fixed management fees and incentive compensation based on performance. Fees paid for absolute return were $144.1 million in fiscal 2021, which represents approximately 26.5% of all management fees. Absolute return comprises 8.7% of SRPS investments. After a number of years of returns below the assumed rate of return, absolute return achieved a 15.51% investment return for the fiscal year, though this return was once again below the benchmark. The system's *Investment Policy Manual* describes the absolute return asset class as, "investments whose performance is expected to exceed the three-month U.S. Treasury bill by 4-5% over a full market cycle and exhibit low correlation to public stocks."

In fiscal 2021, 13 managers achieved returns above the system's 7.40% assumed rate of return. Performance relative to benchmarks was mixed within the asset class, with a little less than half of the absolute return managers achieving returns above the asset class benchmark. A significant number of investments sustained losses with six managers underperforming their benchmarks by more than -10% and one underperforming by more than -20%. Absolute return has returned below benchmarks for the 1-, 3-, 5-, and 10-year periods ending June 30, 2021. Since inception, the returns have exceeded the benchmarks, but that return is only 3.64% against a benchmark of 2.69%. In contrast, the system's cash assets (1.4% of total system assets) have returned 3.68% since inception (against a benchmark of 0.54%) and have outperformed the absolute return assets over the 5- and 10-year periods ending June 30, 2021.

Given the historic low rate of return, underperformance relative to benchmarks, and high management fee structures, DLS requests SRA to comment on the returns of the absolute return asset class, including the market conditions leading to the low level of returns and benchmark underperformance, and what market conditions would result in markedly improved returns for investments in the asset class.

Private Equity Fees

Management fees for private equity comprised nearly 23% of total management fees, while constituting 17.1% of system assets in fiscal 2021. The reason for the higher amount of fees in private equity involves a substantial degree of active management. Fee structures typically include a fixed base management fee, plus a portion of earnings referred to as "carried interest." The management fees only reflect the base fees, not carried interest. Because of the nature of private equity fee arrangements, carried interest fees are tied to performance. When the system pays higher carried interest fees, a higher return on investment is earned by the system. SRA indicates that private equity returns are reported net of management fees and carried interest.

The private equity return was 51.85%, with a benchmark of 53.13%. Investment in private equity has resulted in positive returns for the system with less experienced volatility than public equity. Returns for the 1-, 3-, 5-, and 10-year periods ending June 30, 2021, were 51.85%, 20.93%, 19.76%, and 15.97%, respectively. Returns for the 3-, 5-, and 10-year periods also provided excess returns over the asset class benchmarks. Private equity investment performance has also outperformed peer systems consistently, as noted in Exhibit 5, with the system ranking first for its 10-year returns.

SRA has also been utilizing co-investments in private equity. Such investments are companion investments to private equity funds that SRPS is already investing in but would not carry the same associated fee structure. Under this approach, SRPS is effectively reducing its fees for any private equity investments it co-invests by increasing the invested funds with the co-invested portion of the investment being subject to a lower fee structure. One potential risk in co-investing is that it can result in decreased diversification by consolidating private equity assets in fewer investments. Management of private equity assets will play a crucial role in the continued success of the asset class.

Chapter 202 of 2019 requires SRA to provide more detailed information on carried interest on investments. In the past five years, calls for greater transparency in the reporting of carried interest have led to changes in the investment management industry. Carried interest is earned by investment managers in private markets (*e.g.*, private equity, private real estate) and is the amount that a general partner (investment manager) retains as an ownership interest in the investment profits generated by the partnership. Carried interest typically represents a percentage of the profits generated, with that proportion negotiated among the parties involved. As carried interest represents shared profits that are retained by the general partner rather than paid by the investor, it is not typically reported as investment management fees.

Several public pension plans have begun releasing reports showing carried interest earned by general partners managing investments on their behalf. In addition, the Institutional Limited Partners Association developed a reporting template that includes carried interest that has been endorsed by many investment managers and public pension funds (including SRPS). Chapter 202 requires the board’s annual report on investment management services to include the amount of carried interest on any assets of the system. Carried interest is reported on a calendar year basis to track the system’s financial auditing schedule. For calendar 2020, carried interest was $203.6 million, which indicates an implied share of investment profit of over $1 billion for that period.

DLS requests SRA to provide an update on estimated carried interest for calendar 2021.

Investment Division Staffing

Chapters 727 and 728 of 2018 granted the board authority to set the compensation of personnel in the SRA Investment Division and to establish positions within the division, subject to certain limitations. Investment Division staff are now to be “off-budget” and funded as system expenses. Investment positions are also now outside the State personnel system. The legislation included the creation of the Objective Criteria Committee (OCC) that is charged with making recommendations to the board on the objective criteria to be used for setting compensation and governing the payment of financial incentives to eligible Investment Division staff. OCC made recommendations to the board, and the board included provisions governing the compensation (including incentive compensation) for division staff.

The stated purpose of the legislation by SRA and the board was twofold. First, SRA's Chief Investment Officer (CIO) noted that the ability to create positions and set compensation would reduce compensation-related turnover in the division and help in recruitment to adequately staff the division to perform its existing functions. Testimony submitted in support of the legislation noted that the authority is expected to enhance system investment performance by maintaining and adding staff. The testimony noted that additional staffing resources will "enable the division to expand the universe of potential managers or investments to pursue, enhance the methodology of evaluating those opportunities, or design tactical strategies to adjust the mix of investments for intermediate-term performance." Additional staffing is also intended to free senior investment staff of administrative duties, resulting in increased focus on enhancing investments. The testimony noted that providing the board with authority over positions and compensation "will not result in paying the existing staff more money for doing the same job, but instead, will allow these positions to be more focused on the investment process rather than the administrative and reporting functions." The request for staffing authority contemplated SRA's need to expand its staff resources, as both the complexity of the fund assets and the size of the assets under management is expected to grow.

Since the passage of Chapters 727 and 728, SRA has been able to hire additional staff and move forward into internal management of assets. The Investment Division has grown by an additional 15 positions since passage of the legislation. Periodic review of the division's operations will evaluate the need for additional future positions.

Incentive Compensation

Fiscal 2020 was the first year in which Investment Division staff and the CIO were eligible for incentive compensation under Chapters 727 and 728. SRA reports that based on fiscal 2020 investment performance, 19 staff are eligible for incentive compensation under the guidelines incorporated into the system's *Investment Policy Manual*. Based on fiscal 2021 returns, 21 staff are eligible for incentive compensation. Due to restrictions included in the legislation on payment of incentive compensation in years in which State employees are subject to a furlough, incentive payments are subject to deferral to ensure compliance with this restriction. Incentive compensation is paid out over a two-year period.

Incentive compensation is earned based on the performance of assets under an employee's management. The incentive compensation earned is based on the performance of assets related to the system's actuarial rate of return, the system's policy benchmark, and asset class-specific performance benchmarks. At its November 2021 investment committee meeting, the board approved changes to various asset benchmarks.

As part of Investment Division staff's incentive compensation is tied to performance relative to benchmarks, DLS requests SRA to comment on whether there will be any review

of the benchmark performance thresholds that must be met to be eligible for incentive compensation.

Internal Management of Assets

The second purpose under Chapters 727 and 728 was that the authority over positions and compensation would be necessary to expand and begin moving externally managed assets to internal management by division staff. The timeline indicated for internal management contemplated beginning with passively managed assets toward the end of an initial 2-year phase-in. Internal management would be broadened in years 3 through 5 to types of assets directly managed, including co-investment in private assets. By year 10, as much as 50% of assets could be managed internally. One of the arguments for internal management is that it can reduce fees paid for asset management. SRA estimates savings opportunity through internal management of assets. SRA noted that fee savings of just 1 basis point would net the system approximately $5 million. DLS has previously noted that SRA has been effective at negotiating favorable fee arrangements with external managers, and external management provides SRPS with options to select asset managers and to diversify the management of assets among multiple managers. DLS also previously noted that a shift to internal management would require significant operational changes. Performance measures would need to be adopted to monitor and evaluate the effectiveness of internal management of system assets compared to external management. Additionally, guidelines and reporting requirements would need to be implemented to track the internal management of system funds as well as any expansion or reduction of internal management once implemented.

At the September 2021 board meeting, the system's CIO noted that implementation of the Investment Division staffing and internal management objectives over the next four years will cost roughly $9.4 million and result in an estimated 2025 total budget of $24.6 million. While the Investment Division budget is expected to increase over the next several years, SRA estimates the management fee savings from internal management will far exceed the additional costs. By 2025, SRA expects the total amount of public assets managed internally to be roughly $24.5 billion, while private market co-investments are expected to reach about $2.2 billion. SRA estimates the expansion of internal management to result in fee savings of roughly $86 million in 2025, exceeding the estimated additional cost by approximately $76 million.

Since the passage of Chapters 727 and 728, the system has begun to move assets under internal management. A $2.6 billion U.S. Treasury Inflation Protected Securities passive portfolio was initially funded for July 1, 2019. A $1.1 billion Long Government Bond portfolio was funded for March 1, 2020. The $3.1 billion Russell 1000 portfolio was funded for October 1, 2020, and expanded to its current size in March, and the $0.5 billion Corporate Bond portfolio was funded at the end of fiscal 2021. **Exhibit 8** shows the performance of the system's internal management program.

Exhibit 8
SRPS Internal Management Performance
Investment Performance for Periods Ending June 30, 2021
($ in Millions)

	Total Assets	Fiscal 2021 Actual	Fiscal 2021 Benchmark	Inception Actual	Inception Benchmark	Inception Date
MD TIPS	$2,563.8	6.40%	6.51%	7.61%	7.62%	7/1/2019
MD Long Government Bonds	1,077.9	-9.39%	-10.42%	-2.95%	-4.84%	3/1/2020
MD U.S. Large Cap Equity	3,132.6	n/a	n/a	30.62%	30.69%	10/1/2021
MD Investment Grade Corporate Bonds	530.0	n/a	n/a	n/a	n/a	7/1/2021

MD: Maryland
TIPS: Treasury inflation-protected securities

Source: State Retirement Agency

DLS requests SRA to provide an update on any Investment Division implementation of internal management of system assets and the development of necessary compliance and controls on the use of internal asset management. More specifically, SRA should comment on how the Investment Division:

- **has developed proficiency in managing assets currently being managed internally;**
- **will develop proficiency before expanding into internal management of additional asset classes;**
- **will evaluate the performance of internal management compared to available external management services; and**
- **will develop methodologies for determining fee savings achieved through internal management.**

Terra Maria Program

The Terra Maria program is the system's emerging manager program. One of the Terra Maria program's stated goals is to achieve returns in excess of benchmarks. The program has demonstrated the ability to achieve excess returns over benchmarks, with instances of significant returns over benchmarks at times. Over the past few years, SRPS reorganized the program to better utilize the asset diversification that the program can bring to SRPS. The program transition included eliminating mandates for allocations to large-cap domestic equity and increasing mandates for international small-cap and emerging markets. The program consolidated under five program managers. Program investments in domestic equity in recent years were tracking close to markets, making it more difficult to achieve excess returns in an asset class where it is already difficult to outperform the market, in addition to incurring active management fees. The program has maintained a diverse roster of managers through the transition.

Total assets devoted to the program increased to $2.7 billion in fiscal 2021, up from $2.5 billion in fiscal 2020. As a proportion of total assets, Terra Maria decreased from 4.5% of total assets in fiscal 2020 to 4.0% in fiscal 2021. **Exhibit 9** provides an overview of the Terra Maria program by program manager and asset class.

Exhibit 9
Terra Maria Program Performance
Investment Performance for Periods Ending June 30, 2021
($ in Millions)

		Performance			
	Total Assets	**Fiscal 2021 Actual**	**Fiscal 2021 Benchmark**	**Inception Actual**	**Inception Benchmark**
Program Manager					
Attucks	$580.4	40.51%	33.60%	12.22%	8.51%
Capital Prospects	1,189.7	23.57%	20.78%	12.76%	12.52%
Xponance	374.4	39.89%	43.96%	10.79%	11.24%
Leading Edge	566.7	32.91%	33.60%	11.35%	8.51%
Asset Class(1)					
U.S. Equity	$494.5	63.25%	60.47%	9.39%	9.68%
International Developed Equity	1,519.1	38.23%	35.35%	4.64%	3.14%
Rate Sensitive	637.1	2.10%	-0.07%	5.09%	4.33%
Credit/Debt	58.2	14.20%	12.22%	6.56%	6.24%
Total	**$2,711.3**	**32.10%**	**30.26%**	**6.40%**	**5.92%**

(1) Excludes $2.5 million in emerging market investments.

Note: Actual returns are net of fees; returns beyond one year are annualized. Total assets may not sum to total due to rounding.

Source: State Street – State Retirement Agency of Maryland – Rates of Return – Net Mgr – Periods Ending June 30, 2021

In fiscal 2021, the program experienced a substantial return of 32.10%, outperforming the program benchmark by 1.83%. All four program managers experienced significant returns, and two of the four had a return above the benchmark. Attucks had the strongest performance, with its return of 40.51% outperforming its benchmark by 6.91%. By asset class, three of the four had significant returns that were multiples of the 7.4% assumed rate of return. Only the rate sensitive asset class failed to exceed that mark, though its return of 2.10% was above its benchmark, which expected a loss of -0.07%. Since inception, all four program managers have had returns above the system's assumed rate of return, with three of the four outperforming their benchmark.

Of particular note, the actively managed Terra Maria portfolio experience investment returns that outperformed passively managed system assets and non-Terra Maria actively managed assets. Terra Maria U.S. equity investments returned 63.25% during the fiscal year. Passively managed U.S. equity returned 45.26% during the fiscal year. Actively managed non-Terra Maria U.S. equity investments returned 46.35% during the fiscal year. Terra Maria international developed equity investments returned 38.23% for the fiscal year, compared to a 32.19% return for actively managed non-Terra Maria investments. For U.S. nominal fixed income investments, Terra Maria returned 2.10% compared to returns of -2.13% for actively managed non-Terra Maria investments, and -5.41% for passively managed investments.

Currency Program

Adopted in fiscal 2009, the program is designed to protect against losing value when the dollar appreciates relative to some foreign currencies in countries in which the system holds assets. During periods when the dollar is weak, the currency management program's cost manifests as a slight drag on international equity holdings. However, when the dollar appreciates, the program provides gains that help offset the currency losses generated by the strengthening dollar. As of June 30, 2021, the currency program added total value of $274.7 million since inception. Gains when the dollar is strong should outweigh losses when the dollar is weak, and the system has taken steps to lock in program gains. The primary objective of the program is to lower volatility related to currency fluctuations.

The currency hedging program has limited application and is only applied to a relatively small portion of the system's total assets. In addition, not all foreign currencies are included in the hedging program. Due to liquidity constraints and higher transaction costs in some currencies, the program is currently limited to the euro, Japanese yen, Swedish krona, Swiss franc, Canadian dollar, Australian dollar, and British pound.